M E M O R A N D U M **Staff Summary No. 5**

Date: March 14, 2018

To: Members of the California School Finance Authority

From: Katrina M. Johantgen, Executive Director

Subject: Consideration of Appeal Regarding the Charter School Facility Grant Program for Today's Fresh Start Charter School – Inglewood

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Background: The Charter School Facility Grant Program (SB 740) was transferred to the California School Finance Authority (Authority) in the Governor's 2013-14 Budget Bill. Once transferred, the Authority developed a set of regulations to guide SB 740, its applicants, and staff in reviewing applications for funding. In October 2017, a provision, disallowing schools to seek reimbursement for Charter School Facility Program (CSFP) local match obligations, was added to SB 740 regulations to ensure that state funds received in one program were not used to fund an obligation through another state program. This provision was added to avoid double-dipping into two programs for the same facility costs. Section 10170.4(b)(4) of SB 740 regulations sets forth the prohibition of SB 740 funds used to reimburse CSFP local matching payments: *Costs incurred to meet a Charter School's local match obligation for charter school facilities that receives funds pursuant to the Charter School Facilities Program.* At the time of their adoption, the regulations were in effect for the 2017-18 funding round of SB 740.

Issue: Today's Fresh Start Charter School - Inglewood (TFSCS-I) (CDS 19646340119552) applied to the 2017-18 SB 740 to assist with facility costs for CSFP site located at 3405 W. Imperial Highway, Inglewood, CA 90303. Authority staff reviewed the school's application and supporting documentation provided by TFSCS-I and found the school ineligible. TFSCS-I has exhausted the appeal process, outlined in SB 740 regulations, and is appealing to the Authority board.

Analysis: TFSCS-I first argues that the authorization statute for the Charter School Facilities Program (CSFP) identifies the financing provided pursuant to CSFP as a lease and, therefore, that financing should be a reimbursable expense in SB 740.

While it is impossible to argue with the use of the word "lease" in Education Code section 17078.52, et seq. (the CSFP enabling statutes), it is also important to understand the history behind that terminology. At the time the first bond act that provided funding for CSFP was approved, it was assumed that school districts would apply to this program. Due to constitutional and statutory debt limits that apply to school districts, the Legislature sought to create a funding mechanism that would not run afoul of those debt limits. Hence the creation of a "lease" payment in the statutory language.

Those debt limits do not apply to charter schools, which ultimately have received almost all funding through CSFP.

In that context, what has been created over the years since CSFP was first enacted in 2002, is a program that operates very much like a loan and unlike a lease. A reality recognized by the Legislature when it amended sections 17078.57 and 17078.63 in 2009 and referred to loan payments instead of lease payments. This reality is also reflected in the Memorandum of Understanding and Funding Agreement that TFSCS-I executed in connection with its CSFP award. Numerous provisions in the agreements include terms like "repaying" the State, "interest," and "unpaid principal balance." In addition, Section 1(C) of the Memorandum of Understanding provides that "the State is the **lender** of certain funds to the Charter School to enable the Charter school to acquire real property and/or construct improvements thereon. This **loan transaction** is set forth in the Funding Agreement. This Memorandum of Understanding and the Funding Agreement set forth the entire agreement between the parties regarding **the loan of funds** …"

These agreements, signed by TFSCS-I in 2011, conversely do not include any reference to lease payments or use the word lease anywhere in their provisions. TFSCS-I's reliance on section 2.5(C) of the Funding Agreement and section 2.4(B) of the Memorandum of Understanding is misplaced and not dispositive. Section 2.5(C), which is generally mirrored by section 2.4(B), provides "[t]he obligation to make payments does not constitute an indebtedness of the Charter School **or its chartering authority, within the meaning of any constitutional or statutory debt limitation or restriction and in all cases shall be made solely from legally available funds**." The language in bold was not included in TFSCS-I's appeal and substantially limits what otherwise would appear to be a blanket statement regarding the nature of the obligation.

Finally, while not controlling, the California School Accounting Manual (CSAM) and Generally Accepted Accounting Principles (GAAP) also contribute to a conclusion that the CSFP funding arrangement does not constitute a lease. The CSAM, while not defining "lease" does provide that "facilities rents and leases " are "activities concerned with acquiring facilities through operating leases or rentals without the option to purchase. This function does not include capital lease payments. Capital lease payments are considered debt service …" And GAAP, as established by the Financial Accounting Standards Board, defines "lease" as "an agreement conveying the right to use property, plant or equipment (land and/or depreciable assets) usually for a stated period of time."

Given that TFSCS-I owns the CSFP-financed facility in fee simple, the financing provided by the State and the agreements entered into between TFSCS-I and the State do not constitute a lease. The State did not, and could not, convey use of the facility to TFSCS-I as the State did not and will not own the facility. In addition, assuming that TFSCS-I makes all required payments and continues to operate a charter school, it will have perpetual use of the facility beyond the 30 year term of the funding agreement. In other words, this is equivalent to a loan or mortgage rather than a lease. That the State retains a beneficial interest in the use of the property does not change this conclusion.

TFSCS-I's second argument is that CSFA approved the payment of SB 740 funds for these costs when it found TFSCS-I financially sound, most recently on January 9, 2013. This argument significantly overstates CSFA's authority in conducting its financial soundness reviews. At the time TFSCS-I was found financially sound, CSFA was not administering SB 740. As a result, it had no authority to approve use of those funds for these purposes. TFSCS-I makes a number of secondary arguments based on this "approval" which all fail

because no such approval occurred in the process of CSFA finding TFSCS-I financially sound for purposes of the CSFP program.

TFSCS-I's final argument is that section 10170.4(b)(4) exceeds CSFA's authority pursuant to the SB 740 enabling statute, Education Code section 47614.5. Subsection (m) of section 47614.5 provides CSFA with the authority to adopt regulations implementing the section. TFSCS-I argues that the express limitations found in section 47614.5 that preclude reimbursement for costs charter schools incur in occupying Prop. 39 facilities or school district property limit CSFA from precluding reimbursement for any other arrangements. TFSCS-I appears to be making this argument based on two principles. First, the idea that those two prohibitions found in section 47614.5 are leases and the only leases the Legislature decided to prohibit are for the two specifically identified situations. This argument fails because as described above, while CSFP's statute refers to lease payments, the actual CSFP financing arrangements between charter schools and the State do not constitute leases.

Second, TFSCS-I argues that case law precludes CSFA from establishing clarifying provisions to its regulations. TFSCS-I's argument completely misstates the cases it cites. Both *McGee v. Balfour Beatty Construction* and *Estate of Griswold* deal with cases where plaintiffs attempted to graft onto existing rules additional provisions and sought the court's ratification of those additional provisions. Both courts held that they, the courts, did not have the authority to do so. These holdings are irrelevant to whether a state agency such as CSFA has the authority under its implementing statute and the Administrative Procedures Act to adopt regulations that are clarifying in nature. Ultimately, a regulation that makes clear that a financing arrangement offered by the State that does not constitute a lease is not eligible is entirely consistent with the intent and objectives of the SB 740, which the regulation at issue was adopted to implement.

In sum, TFSCS-I's appeal should be denied because (1) the language of the CSFP statutes notwithstanding, the agreement TFSCS-I entered into with the State is structured as a loan agreement; (2) as structured, CSFP local match obligations, particularly where the charter school holds fee title in the financed project, cannot be considered as leases; (3) CSFA never approved TFSCS-I's use of SB 740 funds for purposes of its CSFP obligations; and (4) CSFA's adoption of section 10170.4(b)(4) was consistent with its regulatory authority.

Recommendation: Staff recommends that for the 2017-18 SB 740 funding round, the funding agreement payment for Today's Fresh Start Charter School - Inglewood remain ineligible for SB 740 funds.

Attachments:
TFSCS-I's Appeal Letter